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The Tax Mire

Years of silly policies have helped create a record fiscal crisis. But if state budgets reveal what matters to us, it's time to carefully consider our priorities.

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On a late October day, Rhode Islanders surrendered $25 million to a cause they held dear. The state was but a month away from an empty till, and State Treasurer Frank Caprio rallied the citizenry to stave off penury with a one-day sale of tax anticipation notes. Governments use TANs to bridge short-term gaps between their spending and tax collections. Institutional investors are the target market, but Caprio opened the sale to hockey moms and plumbers named Joe. He pitched their purchase as an act of patriotism and the newspapers dubbed them war bonds.

It's been a long time since giving the government money was fashionable. The message from the feds on down has been consistent and persistent: Taxes are for losers. And so, as retail financiers dispatched themselves to Bank of America branches selling the TANS to you and me, policymakers adjourned to a war room in the statehouse to hold the fall revenue estimating conference. The two-week, twice-yearly meeting to assess incipient economic trends opened on a discouraging note. Economists variously defined Rhode Island as the state with the nation's highest unemployment rate and as ground zero in the sub-prime mortgage crisis.

Fitch's bond rating service had already taken note. In downgrading the state's creditworthiness earlier that month, Fitch observed: "Rhode Island's financial stress reflects underlying weakness in key revenue sources and numerous tax credit and tax cut programs undertaken in recent years."

"In the first quarter, we know we are running behind," acknowledges Gary Sasse, head of the state's Department of Revenue and a master of understatement. "There are going to be some very, very tough choices."

In the last legislative session, the General Assembly made a series of those to close a $450 million budget gap for this fiscal year—including throwing poor children off state-subsidized childcare and healthcare.

Then, in September, lawmakers learned that the state ended the last fiscal year with a $33.6 million deficit. Rhode Island is hardly alone in the leaky boat. The National Conference of State Legislatures budget update in June documented a sharp reversal of fortunes: In 2007, nearly every state reported stable fiscal conditions. In 2008, twenty states reported budget deficits. Early indications are that 2009 will be still worse, traced to lackluster revenues.

And that brings all of us around to an uncomfortable question: How are we going to pay for stuff? Contrary to what many believe, the government fairy does not fill the potholes. Arturo Perez, an NCSL fiscal analyst, says that states react to deficits in three ways: Raid the rainy day fund, cut the budget, and—as a last resort—raise revenues.

Rhode Island, desperate to rehabilitate its reputation as a cesspool of taxation, has been steadily cutting revenues. Last year brought an end to the motor vehicle excise tax. In 2002, the state began to phase out the long-term capital gains tax and froze it last year at 1.7 percent. In 2004, the state repealed the aircraft sales and use tax. Two years ago, state lawmakers introduced a 5 percent flat tax for the wealthiest Rhode Islanders, a break for top earners in addition to the generous reductions in federal taxes. Businesses, ranging from film production companies to rehabilitators of historic buildings, also got tax rebates, all in the name of economic growth.

Just one tiny detail was missing from the debate on these measures, says University of Rhode Island economist Len Lardaro.

"We did all these fiscal policy matters without asking: Does any of this actually work? You're supposed to check first, not three to five years later," says Lardaro. "In their silly little world everything is independent of everything else. In the real world, everything is linked."

Better late than never, the state has begun to do the math. The Department of Revenue Analysis' preliminary assessment of the motion picture tax credits showed that for every dollar Rhode Island invested, the state reaped twenty-eight cents and lost seventy-two cents.

This summer, Governor Carcieri convened the Tax Policy Strategy Work Group, a group of fiscal policy wonks and business types charged with examining the state's entire tax structure and recommending ways to make it more competitive. The group, which was scheduled to release its report before the 2009 legislative session, was looking at the tax structure's transparency, predictability, efficiency and neutrality. Some group members insisted that "competitive" was not code for "tax cut," but it's hard to see how the state is going to look fiscally inviting by raising any taxes.

The Poverty Institute's Russell Dannecker, who attended the meetings as a member of the public, says the discussions have been too narrowly focused.

"We have a bridge in Pawtucket large trucks can't even go over," he says. "There are so many services needed for good economic advantage: good roads, skilled workers, schools, healthcare, affordable housing. How do you economically develop strictly by making the tax structure more competitive?"

Even John Simmons, a group member and head of the Rhode Island Public Expenditure Council, itself no fan of the state's high tax burden, concedes that the social safety net must be in the mix. RIPEC is separately trying to measure the size of that net with the United Way of South-eastern New England. He also questions whether the General Assembly will be able to respond to any recommendations the tax group may release.

"I wonder whether this is the right time," he says.

That Americans react to the prospect of a tax as though someone sprinkled the Ebola virus on their cornflakes is explained by history and psychology. Humans typically react most strongly to the most immediate evidence. Losses make more of an impression than gains, so research suggests that tax increases resonate more strongly, says Nicholas Epley, of the University of Chicago's Graduate School of Business. Tax cuts have less impact. Psychologically, they are non-events because the government doesn't actually send you a check, he says.

"People have forgotten what their taxes do and they are not reminded," Epley says. "Again, taxes are a personal harm—psychologically more impactful. What you get in return is a diffuse gain; you don't experience it directly."

The connections between taxes and clean water, cheerful elementary schools and the absence of street beggars were once more clearly drawn, says Joseph Thorndike, a tax historian and a visiting scholar at the University of Virginia.

"Up until the 1930s, there was this notion that the federal budget ought to be balanced," he says. "But after the Depression, the connection between taxing and spending never came back and accelerated over time.

"And taxes are complicated," he adds. "In general, Americans are confused about what they pay, what the rich pay, what the poor pay and what those groups should pay."

Budgets—be they state, federal or household—are the purest expression of our values. Veteran state senator Michael Lenihan (Democrat-East Greenwich) observes that the state careened from one tax tactic to another without really considering what the heck our taxes should pay for.

"This story may be apocryphal, but when [Governor] Bruce Sundlun faced a budget crisis that was pretty awful for its day, the first question he asked is: Will someone die if we cut this? If the answer was yes, you didn't touch it," Lenihan says.

"It indicated some sense of priorities—what we want to do versus what we need to do, and for what we want to do, what can we actually afford," he adds. "If you look at current budgets, we don't have an agreement on the goals."

Over the course of World War II, Victory War bonds fetched $187.5 billion from half the population—some of it a dime or a quarter at a time. President Franklin Roosevelt publicly bought the first one and Hollywood film queens promoted them. Frank Caprio is no Rita Hayworth and Governor Carcieri threw cold water on the idea of selling "war bonds" to residents. (He suggested, instead, that the state consider eliminating the income tax, which provides a third of all revenues.)

But small investors responded better than anyone predicted. Maybe they just wanted a safe harbor for their money in the midst of a Wall Street storm.
Or maybe they realized: This is war.